

# **The Tennessee Education Lottery - A Report on Net Lottery Proceeds, the Strategic Dilemma, & Growth Strategies**

**Presented to: The Fiscal Review Committee**

**Presented by: Robert N. Currey**

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## **Presentation Outline**

- 1) Report on Net Lottery Proceeds,  
Unclaimed Prize Money, and Growth
- 2) Breakdown of the Expense Structure
- 3) The Strategic Dilemma, the Solution, and  
the Strategy Options
- 4) Statutory Considerations
- 5) Possible Results & Final Comments

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## From Inception to June 30, 2006

- Gross Revenues = \$2,279,462,350
- Less instant game tickets as prizes = (\$164,821,380)
- Net Revenue (NR) = \$2,114,640,970
- Less Total Expenses = (\$1,494,083,533) (70.7% of NR)
- **Net Lottery Proceeds = \$620,557,437** (29.3% of NR)
- After-School Programs = \$16,314,256
- **Total for Education = \$636,871,693**

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## FY05-06 Actual

- Gross Revenues = \$1,001,702,529
- Less instant game tickets as prizes = (\$68,263,478)
- Net Revenue (NR) = \$933,439,051
- Less Total Expenses = (\$663,576,776) (71.09% of NR)
- **Net Lottery Proceeds = \$269,862,275** (28.91% of NR)
- After-School Programs = \$7,392,700
- **Total for Education = \$277,254,975**

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## FY05-06 Growth

Revenue Source	Net Sales FY04-05	Net Sales FY05-06	Dollar Growth	Percent Growth	Share of Overall Growth
Instant Games	\$538,345,177	\$627,952,797	\$89,607,620	16.6%	62.1%
CASH 3 & CASH 4	\$75,280,740	\$86,949,055	\$11,668,315	15.5%	8.1%
Lotto 5	\$23,398,661	\$22,155,487	-\$1,243,174	-5.3%	-0.9%
Powerball	\$146,674,142	\$190,947,513	\$44,273,371	30.2%	30.7%
	\$783,698,720	\$928,004,852	\$144,306,132	18.4%	100.0%

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## FY06-07 Estimate

Presented to the State Funding Board on May 3, 2006

- Gross Revenues = \$1,026,833,000
- Less instant game tickets as prizes = (\$71,077,000)
- Net Revenue (NR) = \$955,756,000
- Less Total Expenses = (\$688,144,000) (72.0% of NR)
- **Net Lottery Proceeds = \$267,612,000** (28.0% of NR)
- After-School Programs = \$15,000,000
- **Total for Education = \$282,612,000**

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# Breakdown of the Expense Structure

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## TELC Expense Classifications

- **Direct Gaming-Related Expenses** (tied to sales)
  - Prize Expense
  - Retailer Commissions
  - Vendor Fees
- **Non-Direct Expenses** (independent of sales)
  - Advertising Expense
  - Operating Expense

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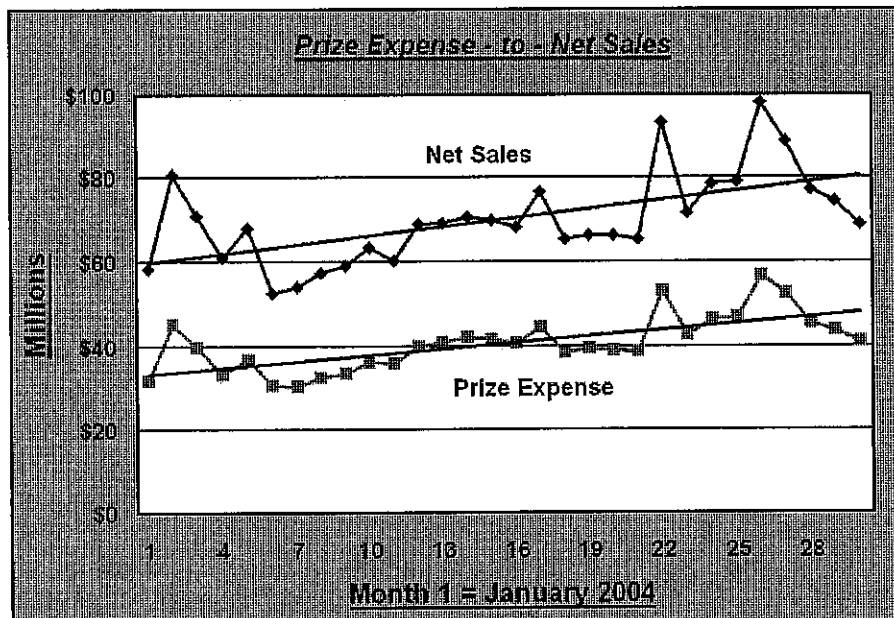
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## Prize Expense

- Expense Type: Direct Gaming-Related.
- Prize expense increases as sales increase.
- **Reduce prize expense...sales will decrease.**
- Less manageable expense.
- Percent of total expenses: 82.2% in FY05-06.
- Percent of net sales: 58.8% in FY05-06.
- Expenditure: \$545.7 million in FY05-06.
- **Plays most strategic role for state lotteries.**

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## Retailer Commissions

- Expense Type: Direct Gaming-Related.
- **Retailer Commissions are statutorily set at no less than 6.5% of gross sales.**
- Less manageable expense.
- Percent of total expenses: 9.8% in FY05-06.
- Percent of net sales: 7.0% in FY05-06.
- Expenditure: \$64.9 million in FY05-06.

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## Vendor Fees

- Expense Type: Direct Gaming-Related.
- TELC contracts with two vendors:
  - (1) GTECH Corp. – Ticket Dispensing Terminals
  - (2) Scientific Games Int'l – Instant Game Products
- **Contractual obligations until 04/09/2011.**
- Less manageable expense.
- Percent of total expenses: 2.9% in FY05-06.
- Percent of net sales: 2.1% in FY05-06.
- Expenditure: \$19.4 million in FY05-06.

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## Advertising Expense

- Expense Type: Non-Direct
- Independent of sales.
- More manageable expense.
- TELC has some discretion on where, how, and when board-approved advertising budget is spent.
- **Small percentage of total expenses and net sales.**
- Percent of total expenses: 2.1% in FY05-06.
- Percent of net sales: 1.5% in FY05-06.
- Expenditure: \$14.1 million.

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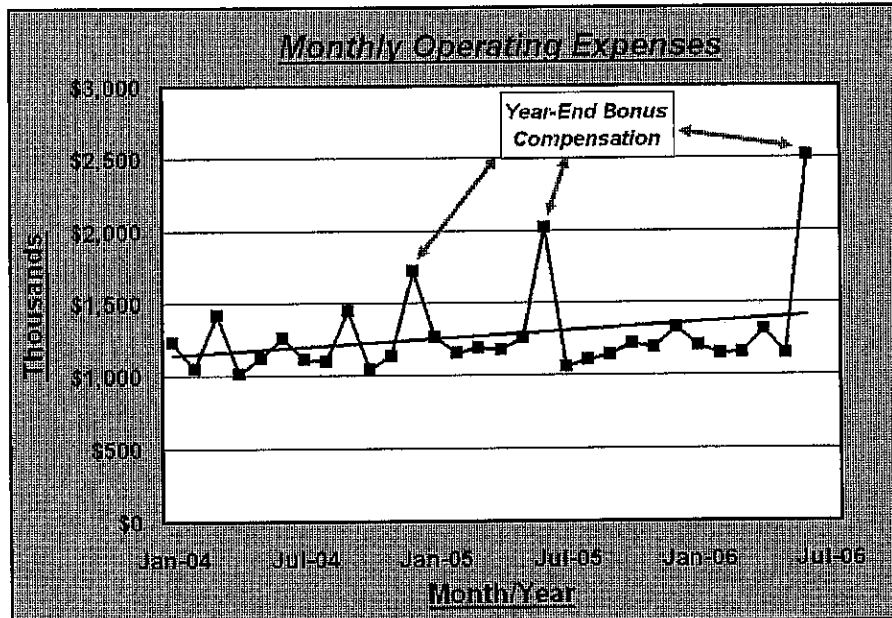
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## Operating Expense

- Expense Type: Non-Direct
- Independent of sales.
- 74% of operating expenses for compensation paid to TELC personnel.
- More manageable expense.
- **Small percentage of total expenses and net sales.**
- Percent of total expenses: 2.3% in FY05-06.
- Percent of net sales: 1.7% in FY05-06.
- Expenditure: \$15.5 million in FY05-06.

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## Key Points to Remember about Expenses

- **Prize Expense** plays most strategic role.
- Prize Expense is the largest expense category (82.2% of TE – 58.8% of NR).
- Direct-Gaming Related Expenses - Prize Expense, Retailer Commissions, and Vendor Fees - are less manageable expenses...(95% of total expenses).
- Non-Direct Expenses – Advertising Expense, Operating Expense - are more manageable expenses...(5% of total expenses).

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# The Strategic Dilemma, the Solution, and the Strategy Options

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## The Strategic Dilemma

- Strategic dilemma: How does a maturing lottery continue to grow net lottery proceeds year-over-year?
- Cannot significantly increase net lottery proceeds by reducing expenses because:
  - 1) Reducing prize expense reduces sales.
  - 2) Retailer commissions are statutorily set.
  - 3) Vendor Fees are contractual obligations.
  - 4) Advertising – small percent of expenses.
  - 5) Operating Expenses - small percent of expenses.

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## Solution and Strategy Options

- Solution: Lotteries must grow net lottery proceeds by continually finding ways to increase net sales.
- Five strategy options the TELC can utilize to grow sales?
  1. Increase prize expense ratios on LOTTO 5, CASH 3, or CASH 4...(least likely option).
  2. Change matrix on LOTTO 5.
  3. Introduce new online games or increase the number of drawings for existing online games.
  4. Market and Advertise for POWERBALL.
  5. **Increase the prize expense ratios on instant game products (most likely option).**

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## Main Strategy

- Theory: Increase the total prize expense ratio...net sales will increase.
- Rationale: If customers believe they have improved chances of winning, they will purchase more tickets.
- Has this strategy worked for lotteries in the past?
- Answer: Yes.
- Will this strategy continue working in the future?
- Short-Term Answer: Most likely.
- Long-Term Answer: Maybe.
- Caution: Any increase in prize expense ratios must be followed by subsequent increases of revenue sufficient to cover the incremental prize expense that will be incurred.

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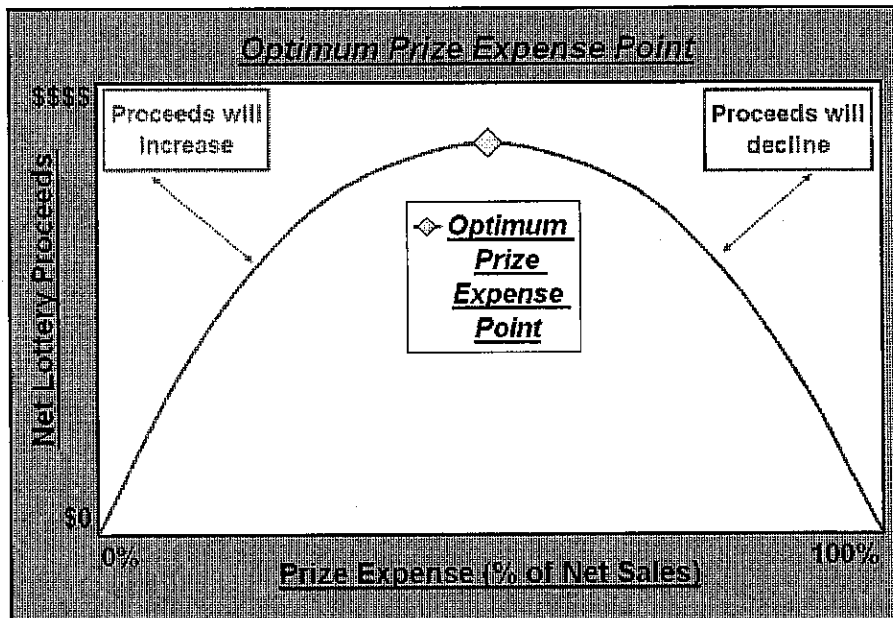
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## Strategy - Goal

- 0% to 100%.....What point in between is the sweet-spot? What point maximizes net lottery proceeds?
- Answer: The point where marginal expense equals marginal revenue.
- $\text{Marginal Expense} > \text{Marginal Revenue} = \text{Net Lottery Proceeds will decrease.}$
- $\text{Marginal Expense} < \text{Marginal Revenue} = \text{Net Lottery Proceeds will increase.}$
- **$\text{Marginal Revenue} = \text{Marginal Expense} = \text{Net Lottery Proceeds are maximized.}$**

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## Strategy - Pitfalls

- Is the current prize expense ratio of 58.8% maximizing our net lottery proceeds today?
- Difficult to know at any given time due to external factors.
- Gas prices, energy costs, inflation, discretionary income, etc...
- **Changes in external factors can cause an optimum prize expense ratio to become less-than-optimum.**
- Makes it a trial-and-error process for lottery management.
- Lag-time can be as long as 3-6 months.

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## Current Strategy Status

- Where is the TELC in terms of utilizing this strategy?
- Last few months: TELC holding prize expense ratios relatively constant (for both instant games and the total prize expense ratio).
- Reason 1: Past prize expense ratio increases...FY03-04 = 55.4%; FY04-05 = 58.2%; FY05-06 = 58.8%.
- Reason 2: Economic uncertainty...inflation fears, rising interest rates, rising gas prices, etc...

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## Short-Term Expectations

- Short-term: (Within current fiscal year)
  - TELC will hold their instant game prize expense ratio relatively constant.
  - Instant Game prize expense ratio  $\approx 64.0\%$  of net sales.
  - Total prize expense ratio will remain relatively unchanged  $\approx 58.8\%$  of net sales.
  - **A new online game will be considered...perhaps even introduced before the end of the fiscal year.**

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## Long-Term Expectations

- Longer-term: (Beyond the current fiscal year)
  - Eventually the TELC will resume the strategy... increase total prize expense ratio...via increasing prize expense ratios on instant game products.
  - Will probably continue (on/off) for a number of years.
  - Matrix change to Lotto 5 might be considered.
  - Increasing prize expense ratios on LOTTO 5, CASH 3 and CASH 4 could be considered...(least likely option).

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## Statutory Considerations

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## Statutory Requirement

- Current statute requires net lottery proceeds be as close to 35% of net revenues as practically possible or some other percentage that maximizes net lottery proceeds.
- If the percentage that maximizes net lottery proceeds is below 35%, then TELC management is to file a statement with the Funding Board stating reasons why they believe proceeds will be higher if allowed to return a smaller percentage of revenues.

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### “The smaller slice of a bigger pie theory”

- If...afforded more flexibility in the *percentage* of revenues they return to the state...
- Then...they can increase the prize expense ratios on their instant games...
- This increases the total expense ratio (expenses as a percent of revenue)...
- When total expense ratio increases...the *percentage* of revenues returned to the state decreases.

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### Best-case scenario

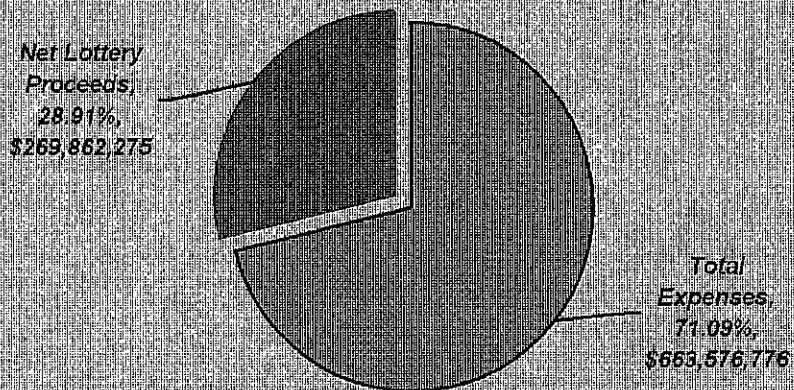
- Hopeful Result...net sales increase enough that net lottery proceeds also increase.
- The net *dollar* amount returned to the state is higher, despite returning a smaller *percentage* of net revenues.

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### Smaller Revenue Pie

Total Net Revenue (actual) for FY05-06 = \$933,439,051



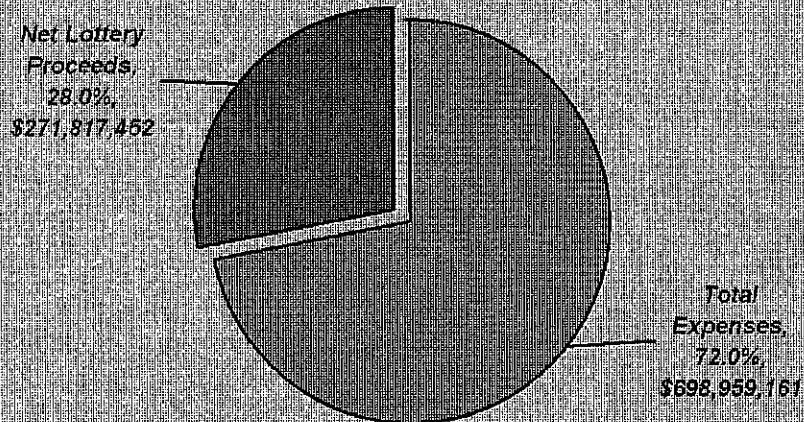
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### Larger Revenue Pie

(with 4% growth)

Total Net Revenue (estimate) for FY06-07 = \$970,776,613



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## Words of Caution

- This strategy typically works best in the formative years for state lotteries.
- Perpetual use of the strategy, year-over-year, typically renders diminishing results.
- **Reason: Law of Diminishing Returns.**
- **Example:** To get the additional \$2 million in net lottery proceeds, net sales had to increase by \$37 million.
- **Worse-Case Scenario:** Net Sales increase by millions, but Net Lottery Proceeds actually decrease.
- **How:** When the incremental revenue that was expected or needed does not materialize.

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## Possible Results and Final Comments

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Category	FY05-06 (Actual)	FY06-07		
		Scenario 1	Scenario 2	Scenario 3
		Sales Growth of 4.0%	Sales Growth of 3.25%	Sales Growth of 3.0%
Net Revenue	\$933,439,051	970,776,513	963,793,840	961,442,223
Revenue Growth (\$)	N/A	37,337,562	30,354,789	28,003,172
Expense Ratio	71.09%	72.00%	72.00%	72.00%
Total Expenses	\$663,576,776	\$698,959,161	\$693,931,565	\$692,238,400
Proceeds Ratio	28.91%	28.00%	28.00%	28.00%
Net Lottery Proceeds	\$269,862,275	\$271,817,452	\$269,862,275	\$269,203,822
Net Lottery Proceeds Growth (\$)	N/A	\$1,955,177	\$0	-\$658,453

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## Final Comments

- Lotteries should **NOT** avoid this as a strategy option.
- State lotteries have used this strategy with much success over long periods of time.
- When used prudently and with caution, this strategy can produce very positive results.
- If used too aggressively...could produce negative results.
- Prize expense ratios will become evermore important to lottery management as time passes.
- Objective: Communicate all the possibilities of utilizing this strategy...the good and the bad.

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